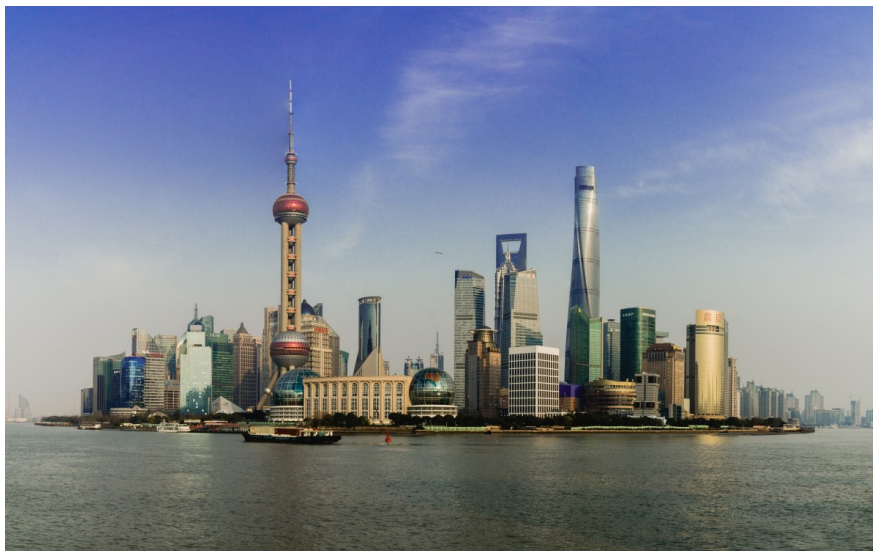


Aluminium: Grinding higher with a self-fulfilling case from ShFE

Some factors that fuelled the market rally in 2Q20 have continued, including a stronger run in the Shanghai Futures Exchange that has propped up arbitrage buying in London, which has helped to reinforce expectations of robust China demand. We think the ShFE bull run is increasingly likely to be a self-fulfilling case



Source: Shutterstock

Prices still grinding higher

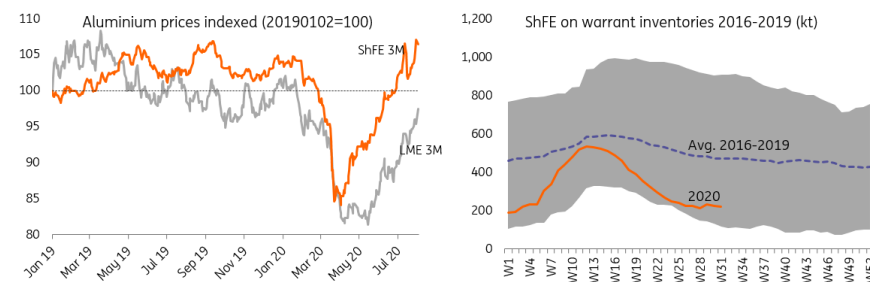
The strength in aluminium prices have continued with London Metal Exchange 3-month prices touching US\$1,747/t yesterday - the highest since mid-February before the major outbreak started outside of China. This is in spite of the fact that the LME on warrant inventories have risen to the highest since April 2017 - the latest reported at 1.6 million tonnes and the nearby spreads had moved to a deeper contango structure.

Yesterday's strong gain was sparked by a fresh dose of optimism coming from the better-than-expected PMI reading from the US.

More promising news came from a rise in P2020 aluminium premium in Rotterdam at the latest US\$90-95/t, the first time since the Covid-19 pandemic took hold of Europe according to

Fastmarkets, and it noted that sellers have seen increased interest from consumers. Looking at its peer in the Shanghai Futures Exchange (ShFE), the strength there is even greater and the prices continued to climb with the most traded third-month contract prices rising by over 3.3% year-to-date.

ShFE aluminium continues to rise amid a mild decline in inventories



Source: Bloomberg, ING

ShFE’s bull case – a self-fulfilling one?

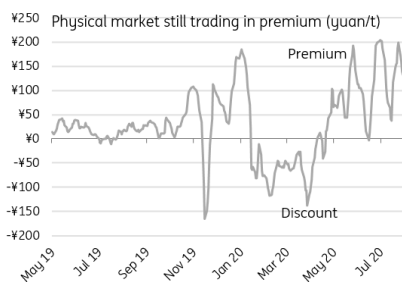
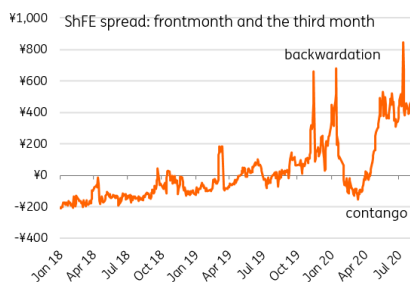
Recent ShFE aluminium has maintained its buoyancy fuelled by inventories that are still on a downwards trend against expectations. In early July, we noted that if the destocking trend holds, it may lead to arbitrage buying in London – a theme that we had previously expected to continue unfolding ([Aluminium: Still standing, for now](#)). There are signs suggesting that physical flows may have continued to find its way to China in July as was the case in June.

Meanwhile, we think the ShFE bull run is increasingly likely to be a self-fulfilling case, and there may be a technical element at play. Notably, the warrants traded in ShFE are backed on aluminium ingots that have to meet a certain standard established by the exchange – it has to be able to be delivered. Some smelters, however, are reported to have been incentivised to produce more billets instead of ingots. And there are reports that some 'strong hands' are holding a large part of warrants in the market that further reduced the warrants availability in circulation. However, the physical prices have been largely in premium and the ShFE market remained stubbornly in backwardation. This suggests difficulty for the bears to roll short positions in ShFE and particularly when it comes to physical delivery. The implication is that as long as all these stay in place, there are fears of risks in shorts being squeezed, which in turn could reinforce a bull case on the ShFE paper market. Hence it seems the ShFE’s bull case is a self-fulfilling one.

But this is not without support from the billet market as inventories of this type of product have also been drawing down, and in our view, this is actually more of a convincing indicator than the primary in terms of the China demand picture, which has not yet darkened. What we fear is that even if billet inventories start to pile up, this may not lead to an immediate 'debug' i.e., ShFE deliverable warrants (backed by ingots) rising and hence allowing a bear trend to set in. Then it will become adverse for those strong hands who are reportedly holding a large portion of warrants if it's true. This will need smelters to be disincentivised by scaling back from billets to more ingots that are physically storable and exchange deliverable instead of billets.

[Aluminium: China aluminium trade snapshot](#)

ShFE aluminium market remains in backwardation



Source: Bloomberg, Antaike, ING